 S-6292

UNCLASSIFIED

CIA/OER/S-06292-74

Role of US Subsidiaries
in East-West Trade

S-6292

Sent copies to:

Mr. Roger Severance
Dept. of Commerce

Jean Tartter
State Department

Edwin Segall
State Department

Susanne Porter
Dept. of Commerce

Charles Van Der Burgh
Dept. of Commerce

Edwin Rendall
Treasury Department

Richard Christensen
State Department

Robert Wright
State Department

Lewis Bowden
Dept. of Commerce

Sherman Abrahamson
Dept. of Commerce

Hertha Heiss
Dept. of Commerce

UNCLASSIFIED

MICRO ONLY

ROLE OF US SUBSIDIARIES IN EAST-WEST TRADE

Office of Economic Research
Central Intelligence Agency
June 1974

UNCLASSIFIED

KEY JUDGEMENTS

This project was undertaken to determine to what extent the activities of subsidiaries in trade with Eastern Europe and the USSR have an effect on the US balance of payments. From the information available -- the lack of data on subsidiary sales being a major obstacle -- the following key judgments emerge:

- Exports of manufactured goods by US subsidiaries are perhaps more than three times the sales from the US to Eastern Europe and the USSR.

- The subsidiaries have the advantage of being located in the countries and industries most involved in East-West trade. Moreover, they have enhanced their ability to compete in this trade by expanding production as well as sales capabilities.

- Some of the advantages enjoyed by US subsidiaries vis-a-vis their parent firms are diminishing.

- The benefits from more flexible credit facilities and fewer export controls in Western Europe are being eroded by wider use of Eximbank financing and a decrease in the US unilateral control list.

- Eastern Europe increasingly prefers to negotiate directly with parent firms -- especially on large deals -- because of political considerations and its desire to obtain the latest technology.

- US subsidiaries probably will at least hold their own in East-West trade. They will ride the coattails of the boom in US-East European trade; a good deal of the business will continue to be subcontracted out to subsidiaries abroad.

UNCLASSIFIED

Background

1. US exports to Eastern Europe and the USSR increased from $354 million in 1970 to $1796 million in 1973. A balance of payments surplus of $1278 million was recorded in 1973 and another large surplus is projected for 1974 on the basis of large contracts signed with several countries -- the USSR, Poland, and Romania in particular. One key factor in the future of US trade with the area will be the activities of subsidiaries of US companies -- especially in Western Europe. They can promote US sales by either acting as marketing agents for the parent firm or by importing from the US raw materials or parts and components for further processing or assembly. Moreover, repatriated earnings along with royalties and fees accruing to parent firms have a positive effect on the US balance of payments. On the other hand, subcontracts for goods and services given to subsidiaries by parent firms will offset some of the potential US gains from the upswing in East-West trade. And direct US exports may be displaced by increases in subsidiaries' production.

2. This paper estimates the importance of US subsidiaries in East-West trade, analyzes the effect of export controls, credit restrictions, tariffs, and tax measures on subsidiary operations, and evaluates the prospects for subsidiaries vis-a-vis US parent firms. The discussion centers on Eastern Europe. US subsidiaries probably have played a smaller part in trade with the USSR because West European commercial ties with the USSR are not as close as those with Eastern Europe. Nonetheless, the general findings -- especially with regard to the effect of credit and trade restrictions -- also apply to the Soviet Union.

Role in East-West Trade

3. US subsidiaries clearly play a substantial role in East-West trade, even though data on direct sales of US subsidiaries to Eastern Europe and the Soviet Union are not available. Total exports of manufactures* by these subsidiaries in Western Europe -- excluding sales to the United States -- rose from $4 billion in 1965 to nearly $6 billion in 1968.

---

* SITC categories 5 thru 8.

West European Exports
of Manufactured Goods

	Billion US $ 1965	1968	Average Annual Rate of Growth 1966-68
Total	54.3	70.3	9%
Of which, by US subsidiaries	4.1	5.9	13%

4. About 3% of all West European exports went to Eastern Europe. If the share of exports by US subsidiaries going to Eastern Europe was the same as the share of total West European sales, US subsidiaries would have exported some $177 million to Eastern Europe in 1968, or nearly 5 times comparable US exports to that area. Projected to 1972,* subsidiary sales would have reached $331 million compared with US exports of only $72 million. On the same basis, exports by US subsidiaries to the USSR would have been $183 million in 1972 while actual US sales totalled $102 million (see Table 1). These figures are consistent with those released in 1970 by the Institute of US Studies in Moscow, which placed the trade of US subsidiaries with socialist countries at $300-$400 million a year.

5. The estimate of sales to Eastern Europe by US subsidiaries in 1972 probably is on the low side. Their total exports of manufactures have been growing at a faster rate than those by Western Europe as a whole -- by 13% compared with 9% in 1965-1968. Based on Western Europe's exports to Eastern Europe, exports by US subsidiaries to this area increased at an estimated rate of 22% per year compared with 17% for Western Europe in 1965-68. If this differential continued, sales by US subsidiaries to Eastern Europe could have been as high as $380 million in 1972 -- over 5 times exports of manufactures from the US itself. Moreover, sales by US subsidiaries of chemicals, machinery, and transportation equipment -- commodities which are increasingly in demand in Eastern Europe -- are rising as fast or faster than West European exports of these products. Sales of these goods also account for a larger share of total exports by US subsidiaries -- 75 percent in 1968 compared with only 55 percent of West European exports of manufactured goods.

6. Finally, by increasing production capacity, subsidiaries are in a better position to directly meet the growing import needs of Eastern Europe. In 1967-72, direct US investment in Europe's manufacturing industries grew by

* Latest year for which data are available.

UNCLASSIFIED

Table 1

Exports of Manufactured Goods to Eastern Europe and the Soviet Union from the United States and from US Subsidiaries in Western Europe; 1965, 1968, and 1972*

(Million US Dollars)

	To Eastern Europe		
	1965	1968	1972
Estimated exports by US subsidiaries	98	177	331
US exports	14	35	72
US exports as percent of exports by US subsidiaries	14	20	22

	To USSR		
	1965	1968	1972
Estimated exports by US subsidiaries	57	118	183
US exports	11	38	102
US exports as percent of exports by US subsidiaries	19	32	56

* Excluding processed food products.

nearly 12% annually. Estimated reinvestment of earnings by subsidiaries themselves showed a similar trend.

7. Subsidiaries are located primarily in those West European countries that have most actively promoted East-West trade -- West Germany, France, Italy, and the United Kingdom. Nearly two-thirds of US manufacturing subsidiaries in Europe were in these four countries in 1968. Furthermore, a Booz, Allen and Hamilton survey revealed that in 1972 new US business activity was greatest in West Germany, Eastern Europe's largest trading partner in the West.*

8. By and large, US subsidiaries -- like their European competition -- are involved mostly in small unpublicized contracts, the bread and butter of East-West trade. US subsidiaries have negotiated a few large deals, however. Kellogg International Corp., a UK-based subsidiary of Pullman Inc., concluded contracts with Romania in 1971 for the construction of three ammonia plants worth $53 million. In 1973 Litwin S.A., a wholly-owned subsidiary of Amtel, Inc., was awarded a $100 million contract -- the largest ever given to a company in France -- to design and equip a styrene-polystyrene complex in the USSR. In addition, subsidiaries of such major US firms as Occidental Petroleum, Singer, Honeywell, and Litton Industries, have been active in East-West trade.

9. Subsidiaries undoubtedly have performed a large volume of subcontracting, especially with the recent upsurge in US-East European trade. Parent firms after all consider subsidiaries as components of the total corporate system and not as competitors. Some, such as the Dow Chemical Corp., go so far as to have their subsidiaries handle all sales to Eastern Europe and the USSR. Dow's trade with the USSR -- amounting to $200 million annually -- involves the sale of finished products by subsidiaries in return for Soviet raw materials.

Subsidiaries vs. Parent Firms

10. Whether competitors or not, US subsidiaries in Western Europe have had a distinct edge over parent firms. Although they have been affected somewhat by US trade re-

* The activities covered by the Booz, Allen and Hamilton study included the establishment of new business units, the expansion of previously established ones, and licensing agreements involving an exchange of proprietary rights with a foreign group.

UNCLASSIFIED

strictions (especially export controls), US subsidiaries by virtue of proximity to the market, more flexible credit facilities, and tax and tariff breaks have enjoyed some measure of parity with other Western firms in trade with the USSR and Eastern Europe. Moreover, since Communist countries tend to buy where they sell, if subsidiaries in traditional West European markets can provide US technology, so much the better.

Export Controls

11. Up to the late 1960s, US subsidiaries were constrained by US controls on sales to Communist countries in addition to the COCOM controls generally followed by NATO countries. As late as 1968 the US Commodity Control List (CCL) contained 1300 entries over and above the COCOM List. Subsidiaries were not allowed to export goods manufactured abroad if the comparable US product appeared on the CCL. This restriction applied to goods containing no US components or technology, even if their sale was not restricted by the country in which the subsidiary was located.

12. Beginning with the Export Administration Act in 1969, subsidiaries -- and their parent companies -- have benefitted from a substantial liberalization of export controls. The gap between US and COCOM controls has been narrowed to only 73 products or product groups, primarily electronic equipment. US subsidiaries are now at much less of a disadvantage compared with other Western firms. And the United States is continuing to review and reduce the unilateral control list.

13. In 1972, the ban was lifted on subsidiaries' sales of goods similar to US products on the control list. For products made abroad, subsidiaries now fall under host country export controls. But a re-export license still must be obtained for subsidiary exports containing imported US components that are on the CCL.

14. On balance, a further easing of US export controls probably would put subsidiaries in a more favorable position compared with parent firms. On the one hand, since many of the subsidiaries have been producing or could produce commodities on the US unilateral list for sale in Western Europe, traditional business ties and proximity to Eastern Europe would give them an advantage in selling restricted commodities as they are decontrolled. On the other hand, where parent firms have a wider range of goods and technology to offer, East European buyers may well bypass the subsidiaries.

UNCLASSIFIED UNCLASSIFIED

Credit Restrictions

15. Unlike export controls, US credit restrictions have not applied to subsidiaries, which have been operating in a much more liberal atmosphere in Western Europe. In particular, subsidiaries have been able to secure the assistance of West European governments in financing exports to Communist countries. Except for Yugoslavia, Romania, Poland, and the USSR, the US Export-Import Bank is prohibited from participating in, guaranteeing, or insuring private commercial credits or exports to Socialist countries.

16. Moreover, subsidiaries have not been saddled with the US limit of 5 years for government-guaranteed or insured commercial credits to Eastern Europe -- an especially severe restriction when capital goods are involved. The members of the Berne Union,* mostly West European countries, agreed to the five-year rule largely at the urging of the US but have not adhered to it. For example, in 1964 the UK provided a $300 million 15-year commercial loan to the USSR, and France insured a ten-year consortium loan to the USSR exceeding $300 million.

17. Subsidiaries also have not had to comply with restrictions on guaranteed private credits which date back to the Johnson Act of 1934 -- legislation prohibiting loans to foreign countries in default on their debts to the US. Although the act was not aimed at Communist countries in particular, until recently it affected all of them except Albania and Bulgaria -- which were considered not to be in default to the US -- and Yugoslavia -- which came under an exemption granted for members of the World Bank and the International Monetary Fund. A series of rulings have watered down the Johnson Act's prohibition. Private credits generally can be used to finance commercial exports as long as the extension of credit is held to five years or less. Thus restrictions continue on long-term credits.

18. Wider use of US Eximbank financing since the early seventies has dulled the credit edge enjoyed by subsidiaries. Eximbank is competitive with European credit facilities through the use of subsidized interest rates and deferred payments. Payments, for example, often are delayed until the date of delivery or completion of the project, which results in a debt maturity period of more than five years. The European

* The Berne Union was formed in 1934 to coordinate the granting and guaranteeing of export credits. The US has never been a member.

Economic Community is expected to ask the US and Japan to sign a "gentlemen's agreement" setting minimum standards for export credits granted on transactions with Eastern Europe and obliging member nations not to grant government loans or credit insurance at less than 7 percent, nor allow the duration of the credits to exceed 8-1/2 years.

Tariff and Tax Incentives

18. Subsidiaries probably have gained some advantage from the most favored-nation (MFN) treatment granted to the USSR and most of Eastern Europe by Western European countries. Tariffs undoubtedly have provided a commercial and political environment more conducive to trade between Eastern and Western Europe. But MFN status granted by the US to Poland in 1960 has not had a visible impact on their exports and by no means caused them to divert imports from US subsidiaries in Europe. Granting MFN to countries like East Germany and Czechoslovakia might have a greater impact on their exports to the US; about three-fourths of their exports in 1970 to the US were subject to tariffs substantially higher than MFN rates.

19. Operating under the West European tax system has given subsidiaries a clear advantage over their parent companies. Western Europe's value-added tax exempts exports and permits lower corporate taxes -- the net effect being a government export subsidy. For total exports, the subsidy gives the US subsidiaries only a slight advantage. But for highly processed commodities such as machinery, a large share of the price represents additions to value. For these products the price advantage could be significant.

20. US tax laws also promote the transfer of sales, technology, and production facilities to foreign operations. Parent firms can defer federal income taxes on earnings of foreign subsidiaries until profits are repatriated and can claim full credit for foreign tax payments against their US income tax liability. For example, a subsidiary in Switzerland earning $100,000 and paying $30,000 in Swiss taxes is liable for only $3,600 (48 percent of the total $70,000 minus a $30,000 tax credit) in US taxes -- assuming repatriation of the remaining $70,000. The result is an effective tax rate of 33.6 percent on the $100,000 income.

Outlook

21. Subsidiaries should at least hold their own in the general expansion of East-West trade and could well increase their share of the trade. Because of proximity, increased

UNCLASSIFIED

capacity, and tax incentives, they are in a good position not only to trade directly with the East, but also to take on more subcontracting as US-East European trade grows. US subsidiaries will continue to have an advantage over their parent firms in terms of credit facilities, at least until Eximbank credits are extended to the rest of Eastern Europe. The current trade pattern is likely to hold; subsidiaries will handle a growing volume of smaller day to day transactions and parent firms will negotiate most of the large "one-shot" deals. The East Europeans may well want to deal directly with US parent firms but are aware that much of the business will be carried out by subsidiaries.

22. In addition to direct sales, subsidiaries will have a substantial role in the increasingly important licensing and joint venture agreements with Eastern Europe. Cooperative ventures will broaden trade by putting more emphasis on exchange of components and technology as opposed to finished products. For example, under the terms of a 1971 joint production and licensing agreement, Ratier Forest -- a United Aircraft Corporation subsidiary located in France -- will supply its Hungarian partner with technology and components for the output of metal cutting tools. Similarly, in 1972, Clark Equipment A.G. in Switzerland agreed to provide Poland with production rights and technical assistance for the manufacturing of axles for heavy construction equipment and vehicles. Sale of the finished product in the West was to be handled by a Clark marketing subsidiary.

23. Thus US subsidiaries will continue to play a dual role so far as the US balance of payments is concerned. They will promote US products and technology in Eastern Europe and indirectly generate some home-based US exports to the area. But, in addition, their own direct sales and subcontracting activities will act as an offset to potential US export gains.